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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

WESTERN DIVISION

CATHERINE A. ZULFER,

Plaintiff,

v.

PLAYBOY ENTERPRISES, INC. and DOES 1 through 10, inclusive,

Defendants.

Case No. CV12-08263-MMM (SHx)

DEFENDANT PLAYBOY ENTERPRISES, INC.'S REPLY MEMORANDUM IN FURTHER SUPPORT OF ITS MOTION TO DISMISS PLAINTIFF'S FIRST AND SECOND CAUSES OF ACTION, AND TO STRIKE ALLEGATIONS PURSUANT TO FED. R. CIV. P. 12(b)(6) AND 12(f)

Date: February 11, 2013
Time: 10:00 a.m.
Judge: Hon. Margaret M. Morrow
Courtroom: 780

Trial Date: None Set

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I. INTRODUCTION

Plaintiff Cathy Zulfer ("Zulfer") sued defendant Playboy Enterprises, Inc. ("Playboy" or the "Company") as self-styled Sarbanes-Oxley Act ("SOX") whistleblower. Zulfer claims that she was "extremely concerned" that Playboy's Chief Executive Officer, Scott Flanders ("Flanders"), and Chief Financial Officer, Christoph Pachler ("Pachler"), were attempting to "embezzle, steal or convert Playboy assets" by somehow forcing or tricking the Company and its Board of Directors to pay them large bonuses that she personally did not feel that they earned. What does she allege Flanders and Pachler actually did in their supposed attempt to "embezzle, steal or convert Playboy assets"? Zulfer's sole specific, factual allegation is that Pachler twice requested that she accrue (that is, record as an expense on the Company's books, but not actually pay) an amount for 2010 incentive bonuses before Playboy's Board of Directors ("Board") formally approved the amount of the 2010 bonus pool. She offers —

- no allegation that Flanders or Pachler went behind her back to make the accrual;
- no allegation that Flanders or Pachler actually stole any money;
- no allegation that Flanders or Pachler created phony documents;
- no allegation that Flanders or Pachler misled the Board or the Company's auditors;
- no allegation that she did anything to confirm her position – e.g. no allegation that she checked with the Board or Compensation Committee as to the propriety of the requested accrual; and
- no allegation that the Board did not approve the bonus payments (which it did shortly thereafter and in the normal course of the Company's governance process).

Her only factual allegation is that Pachler twice asked her to make an accrual in the Company's internal accounting records, and that she said no, apparently because she believed that Board approval in advance of the accrual was required. That's it.

This allegation falls far short of what is required to state a claim for relief under the SOX whistleblower provisions — specifically, facts showing that Zulfer had an objective reasonable belief that Pachler's requests to make an accrual rose to the level of one or more of the six enumerated categories of wrongdoing under the statute: (1) mail fraud; (2) wire fraud; (3) bank fraud; (4) securities fraud; (5) a violation of a Securities & Exchange Commission ("SEC") rule or regulation; or (6) violation of federal law relating to shareholder fraud. See Van Asdale v. International Game Tech., 577 F.3d 989, 996 (9th Cir. 2009) (citing 18 U.S.C. § 1514A(a)(1)).

Zulfer failed to identify in the Complaint which of these categories she was invoking. Accordingly, in moving to dismiss, Playboy made an educated guess that she was proceeding under the sixth "catch-all" category, a violation of federal law relating to shareholder fraud. With respect to this sixth category and as demonstrated in our opening memorandum, Zulfer failed to plead facts showing that (1) that she had a reasonable belief that Flanders' and Pachler's actions constituted (or even threatened) fraud on Playboy's shareholders; and (2) a false statement was issued to shareholders, both of which are required showings. Zulfer does not and cannot offer any basis other than speculation to suggest that accruing a bonus expense before Board approval is wrong and, thus, the mere fact of a request to do so can be presumed to be false or fraudulent. At most, whether to accrue a bonus is an accounting judgment with which she apparently disagreed. That is not fraud. Given her self-professed experience as an accountant, she should have and would have known that. Thus, she could not have had a reasonable basis to suspect the requests for an accrual amounted to fraud.

Another fatal deficiency is that no false statement ever was issued to shareholders. Zulfer argues that the reason no false statement was issued to shareholders was that she stopped the "fraud" by not making the accrual before Board action. But the chain of events that would have to occur for the court to consider this a reasonable inference is too far – in effect, it is a "chain of speculation." The Company issued its 2010 financial statements publicly in mid-February 2011, after the Board made its bonus pool decisions and after the Company's outside auditors had a chance to review the financials. Even if the Board had not approved the bonus pool, Zulfer offers no factual allegation supporting a reasonable basis to believe that any inaccurate accrual would not have been revised in the ordinary course before the financials were issued to shareholders. In the ordinary course, the Board would vote on the bonus pool before the financials were issued to shareholders and the auditors would review the Company's books and financial statements before the financials were issued to shareholders. In light of this, it would be implausible to infer that Flanders and Pachler intended to commit fraud on the shareholders, or were deliberately reckless as to the risk of misleading shareholders, at the time of the requested accruals. It is likewise implausible to infer that Zulfer's belief that the requested accrual threatened a fraud on Playboy's shareholders was objectively reasonable.

Perhaps recognizing that she cannot adequately plead a SOX claim based on the sixth category, Zulfer attempts in her opposition to recast her Complaint by relying heavily on the fifth category of SOX, a violation of an SEC rule or regulation. Zulfer points to SEC Rule 13a-15 promulgated under Section 13 of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78m. The facts alleged in the Complaint, however, do not come close to pleading a violation of Rule 13a-15. That rule governs the maintenance and evaluation of systems of internal disclosure and financial controls. See 17 C.F.R. § 240.13a-15. Zulfer does not allege that Playboy failed to implement, maintain or evaluate its systems of internal

disclosure and financial controls. Instead, Zulfer alleges that Pachler followed the normal process for requesting an accrual, by his requests to her. Again, there is no allegation (nor could there be) that Pachler bypassed her to make the accrual.

Further, although Zulfer does not cite SEC Rule 13b2-1 (regarding books and records) in her opposition, the Court should not permit her to amend on the basis of this rule. Rule 13b2-1 makes it unlawful for any person to "falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the" 1934 Act. 17 C.F.R. § 240.13b2-1. Again, an expense accrual is not "false" just because the amount of the expense might turn out to be different. By definition, an accrual for an expense is entered on the books before payment actually is made. It is essentially an estimate, whose amount is subject to some level of uncertainty. Zulfer readily acknowledges this, recognizing in her opposition that accounting rules call for an accrual when the expense is "likely" (not "certain") and when the amount is "reasonably estimable" (not "definitively quantified"). Both are judgment calls. This was, at most, a difference of opinion about booking a reserve for a future contingent liability. A mere difference of opinion regarding an accounting judgment does not establish fraud or create a falsehood in violation of SEC rules or regulations, and certainly does not move Zulfer's claim into the zone of plausibility.

Worse here, is that the sole alleged basis for Zulfer's opinion appears to be her personal view that Flanders and Pachler did not deserve bonuses. But it was not up to her to decide her bosses' compensation. As she acknowledges, that was the Board's decision. It is the height of hypocrisy for Zulfer to complain now about phantom attempts by Flanders and Pachler to bypass internal controls when it was she herself who sought to do precisely that by substituting her judgment for that of the Company's Board of Directors. In short, the facts alleged in the Complaint (as distinct from Zulfer's speculation) fail to show "more than a sheer possibility" that she reasonably could have believed that Flanders and Pachler were acting unlawfully and fail to "exclude the possibility" that Zulfer should have known

Pachler's requests for an accrual were within reasonable accounting judgment consistent with the Company's internal accounting controls.

With respect to Zulfer's California Labor Code § 1102.5 claim, Zulfer concedes that she failed to make a report to a qualified governmental or law enforcement agency. Instead, she makes the novel argument that Playboy should be considered a government agency because it has certain governmental "reporting obligations." This argument has zero support in any authority and would require a rewrite of the California Labor Code. Finally, Zulfer offers no reasoned basis for denying Playboy's motion to strike irrelevant and scandalous allegations from the Complaint.

For the reasons set forth in the opening memorandum and below, the Court should grant Playboy's motion in its entirety.

II. ARGUMENT

A. Zulfer Must Plead Particularized Facts Showing that Her Claim is Plausible, Not Merely Possible, and Tending to Exclude Alternative, Non-Wrongful Explanations for Defendants' Alleged Conduct

In Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007), and Ashcroft v. Iqbal, 556 U.S. 662 (2009), the Supreme Court established a new standard for evaluating the sufficiency of a complaint under Federal Rule of Civil Procedure 12(b)(6). As the Ninth Circuit recently observed in In re Century Aluminum Co. Sec. Litig., ___ F.3d ___, 2013 U.S. App. LEXIS 24 (9th Cir. Jan. 2, 2013), the Supreme Court's decisions in Twombly and Iqbal "moved us away from a system of pure notice pleading. In addition to providing fair notice, the complaint's allegations must now suggest that the claim has at least a plausible chance of success." Id. at *6 (citing Charles Alan Wright, et al., Federal Practice and Procedure § 1216, at 71 (Supp. 2012)). "The plausibility standard," the Supreme Court held, "asks for more than a sheer possibility that a defendant has acted unlawfully." Iqbal, 556 U.S. at 678 (citations omitted).

To meet this standard, "the complaint must allege 'factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.'" Century Aluminum, 2013 U.S. App. LEXIS 24, at *6 (quoting Iqbal, 556 U.S. at 678) (emphasis added). As the Supreme Court explained, "[d]etermining whether a complaint states a plausible claim for relief will . . . be a context-specific task that requires the reviewing court to draw on its judicial experience and common sense." Iqbal, 556 U.S. at 678; accord Century Aluminum, 2013 U.S. App. LEXIS 24, at *7.

Significantly, "[w]here a complaint pleads facts that are 'merely consistent with' a defendant's liability, it 'stops short of the line between possibility and plausibility of "entitlement to relief."'" Id. (citations omitted). In Century Aluminum, the Ninth Circuit applied this concept in affirming the dismissal of a claim under Section 11 of the Securities Act of 1933 on the ground that plaintiffs failed to show that the shares they purchased were traceable to the stock offering made under the challenged prospectus. The complaint's defect, the Court explained, was plaintiffs' failure to plead "facts tending to exclude the possibility that the alternative explanation [suggested by defendant] is true":

> When faced with two possible explanations, only one of which can be true and only one of which results in liability, plaintiffs cannot offer allegations that are "merely consistent with" their favored explanation but are also consistent with the alternative explanation. Iqbal, 556 U.S. at 678 (internal quotation marks omitted). Something more is needed, such as facts tending to exclude the possibility that the alternative explanation is true, see Twombly, 550 U.S. at 554, in order to render plaintiffs' allegations plausible within the meaning of Iqbal and Twombly. Here, plaintiffs' allegations remain stuck in "neutral territory," Twombly, 550 U.S. at 557.

2013 U.S. App. LEXIS 24, at *9-10 (emphasis added).

Zulfer does not dispute that Rule 9(b) applies to her Complaint; thus, as demonstrated by Playboy in the opening memorandum, Zulfer must plead her claims with the heightened degree of particularity required by Federal Rule of Civil Procedure 9(b). See Defendant Playboy Enterprises, Inc.'s Notice of Motion and Motion to Dismiss ("Open. Mem.") at 5 (Rule 9(b) requires plaintiff to specify the "who, what, when, where and how" of the alleged fraud) (citing Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1106 (9th Cir. 2003)). Courts have long recognized that Rule 9(b) serves to deter nuisance suits and "safeguards defendant's reputation and goodwill from improvident charges of wrongdoing." Vess, 317 F.3d at 1104 (citation omitted).

Zulfer's Complaint suffers from the same core defect as the complaint in Century Aluminum: an absence of particularized factual content suggesting "more than a sheer possibility that a defendant has acted unlawfully" (Iqbal, 556 U.S. at 678) or "tending to exclude the possibility" that defendant acted lawfully. Century Aluminum, 2013 U.S. App. LEXIS 24, at *10. This defect is exacerbated by her failure to make what are very serious accusations – fraud, embezzlement, theft – against Flanders and Pachler with the particularity required by Rule 9(b). The Court should infer from the absence of specific factual allegations that facts necessary to support her claim do not exist and could not be alleged in an amended complaint. The Court should dismiss Zulfer's SOX claim, with prejudice.

B. Zulfer Fails to State a SOX Claim Under Twombly/Iqbal and Rule 9(b)

1. Zulfer Fails to Plead an Objectively Reasonable Belief of an Existing SOX Violation

In the opening memorandum, Playboy demonstrated that Zulfer fails to plead an objective, reasonable belief that defendants were engaged an actual, existing violation of any of the categories in Section 1514A. See Open. Mem. at 8. As the Fourth Circuit held in Livingston v. Wyeth, Inc., 520 F.3d 344, 352 (4th Cir. 2008), "the [SOX] statute requires [plaintiff] to have held a reasonable belief about an

existing violation, inasmuch as the violation requirement is stated in the present tense: a plaintiff's complaint must be 'regarding any conduct which [he] reasonably believes constitutes a violation of [the relevant laws].'" Id. at 352 (citing 18 U.S.C. § 1514A(a)(1)). In Livingston, the Court recognized that allegations of securities fraud dependent upon a "chain of speculation" do not support a valid SOX claim:

> In order to anticipate a misrepresentation to the FDA, [plaintiff] would have to assume that the new training documentation system would not actually be implemented by the September 30 commitment date; that [defendant] would fail to develop an acceptable legacy plan to afford it additional time to close any remaining compliance gaps; and that [defendant] would then misrepresent or conceal the true status of the program. This chain of speculation is simply too long to support a claim that [defendant] in fact covered up anything and made misrepresentations to the FDA or was in the process of doing so, as is required to support a violation of the securities laws.

Id. at 354 (emphasis added in part); see also Walton v. NOVA Info. Sys., Case No. 3:06-CV-292, 2008 US Dist. LEXIS 29944, at *25 (E.D. Tenn. Apr. 11, 2008) ("At best, Plaintiff had a 'belief that a violation [was] about to happen upon some future contingency,' namely the failure to comply with database security standards and the failure to make required disclosures. However, as the Livingston court recognized, such speculative beliefs do not comprise an existing violation as required by [SOX].").

Zulfer's SOX claim is similarly made up of a tenuous "chain of speculation." A violation could have occurred, according to Zulfer, at some point in the future if, among other things, (a) she or someone else accrued the bonus pool, and (b) the Board did not approve the bonus pool, and (c) she or Pachler did not immediately revise the accrual accordingly, and (d) the auditors did not revise the accrual, and (e) uncorrected financials were issued to shareholders. Zulfer seems to acknowledge

the contingent nature of the alleged threatened fraud. See, e.g., Plaintiff's Memorandum of Points & Authorities in Opposition to Playboy's Motion to Dismiss ("Opp. Mem.") at 20 & n.9 (speculating that shareholder fraud "may have" occurred "[i]f the bonuses were accrued and left on the books by the February 2011 Form 8-K filing, but no Board approval had occurred") (emphasis added).[1]

Under Livingston and Walton, the acts alleged by Zulfer here to constitute a violation under SOX (Pachler's two requests for an accrual) are subject to too many future contingencies and too much speculation to support an objectively reasonable belief that a violation was in the process of taking place. As a matter of law, therefore, the SOX claim must be dismissed.

2. Zulfer Fails to Plead an Objectively Reasonable Belief that Flanders and Pachler Were Engaged in Shareholder Fraud

To have an "objectively reasonable belief there has been shareholder fraud," Zulfer's "theory of fraud must at least approximate the basic elements of a claim of securities fraud." Van Asdale, 577 F.3d at 1001 (quoting Day v. Staples, Inc., 555 F.3d 42, 55 (1st Cir. 2009)); accord Allen v. Administrative Review Board, 514 F.3d 468, 480 & n.9 (5th Cir. 2008). As the First Circuit explained in Day, to successfully state a SOX claim based upon shareholder fraud, "the employee must have an objectively reasonable belief that the company intentionally misrepresented or omitted certain facts to investors, which were material and which risked loss." 555 F.3d at 56. Zulfer does not dispute this standard.

In the opening memorandum, Playboy demonstrated that Zulfer's Complaint has three main defects in its attempt to "approximate the basic elements of a claim

[1] Playboy submitted with its motion certain of the Company's filings with the SEC which demonstrate the timeline of corporate disclosures relevant to Zulfer's claim. We explained that the court may take judicial notice of those filings and consider them in making its ruling on this motion to dismiss. See Open. Mem. at 5-6. Zulfer does not contest our request that the court take judicial notice of these materials.

of securities fraud": (1) Zulfer fails to identify a misrepresentation communicated to shareholders on which shareholders relied; (2) Zulfer fails to plead facts plausibly suggesting Flanders and Pachler acted with an intent to defraud shareholders or were reckless as to the risk shareholders would be misled; and (3) Zulfer fails to plead any risk of economic loss to shareholders caused by Flanders' and Pachler's alleged misconduct. See Open. Mem. at 9-15.

As to the first and third points — lack of a misrepresentation to shareholders and lack of economic loss — Zulfer argues that these showings are not required, as it would tend to undermine a claim of a whistleblower who successfully stops a fraud before it is completed. See Opp. Mem. at 20-21. Unfortunately for Zulfer, the case law clearly requires an actual communication to shareholders to support a SOX claim predicated on shareholder fraud. See Day, 555 F.3d at 55 (requiring an actual intentional misrepresentation or omission of facts to investors and at least a risk of loss); id. at 57 (affirming summary judgment dismissing SOX claim where the employee "has not alleged that the numbers he complained were inaccurate . . . were reported to shareholders"); see also Allen, 514 F.3d at 479 ("We find that [plaintiff's] general inquiries concerning SAB-101 compliance in [defendant]'s internal financial documents, which she knew were not released to shareholders, do not constitute protected activity under SOX.") (emphasis added).[2]

Even if a threat of a misrepresentation or omission of facts to shareholders were all that was required, Zulfer fails to allege that as well. This is not a case where the whistleblower heroically stops the bike messenger seconds before she can

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[2] Zulfer relies upon Smith v. Corning Inc., 496 F. Supp. 2d 244 (W.D.N.Y. 2007), and Mahony v. Keyspan Corp., Case No. 04 CV 554 SJ, 2007 WL 805813 (E.D.N.Y. Mar. 12, 2007), to support her assertion that the mere possibility incorrect financial information might eventually make its way to shareholders is sufficient to state a SOX claim predicated on shareholder fraud. See Opp. Mem. at 21 n.10. Both of these district court decisions predate the contrary Circuit court decisions in Day and Allen, as well as the Supreme Court decisions in Twombly and Iqbal. Accordingly, they are not persuasive authority on this point.

deliver a fraudulent Form 10-K to the SEC. Pachler's request that Zulfer enter an accrual on the Company's internal books and records was far removed from the publication of financial statements that go to shareholders. Numerous checks and balances, including Board approvals and auditor review, stood between Pachler's accrual requests and eventual issuance to shareholders of the Company's financial statements. The only way Zulfer could possibly connect Pachler's two requests for accrual to these two "basic elements of a claim of securities fraud" is to engage in the kind of "chain of speculation" rejected by the courts as insufficient under SOX. See, e.g., Opp. Mem. at 20 & n.9 (speculating that shareholder fraud "may have" occurred "[i]f the bonuses were accrued and left on the books by the February 2011 Form 8-K filing, but no Board approval had occurred"). The "sheer possibility" that incorrect accruals might eventually find their way into financial statements and mislead shareholders does not pass muster under Twombly/Iqbal.

As to the second point — scienter — Zulfer fares no better. As an initial matter, Zulfer cites the wrong standard for inferring scienter in the Ninth Circuit. See Opp. Mem. at 22 (citing ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 98 (2d Cir. 2007)). The Ninth Circuit long ago rejected the "motive and opportunity" test applied by the Second Circuit and cited by Zulfer. See In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999) ("Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud an opportunity to do so."). Thus, in the Ninth Circuit, a securities fraud plaintiff must "state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity." Id.

In Allen, the Fifth Circuit effectively applied the Ninth Circuit scienter standard to a SOX claim based upon shareholder fraud. The Court held that "[i]n cases involving the sixth 'catch-all' category [of SOX], we conclude that the employee must reasonably believe that his or her employer acted with a mental state

embracing intent to deceive, manipulate, or defraud its shareholders." 514 F.3d at 480. Here, the only remotely relevant, concrete allegations of fact in the Complaint are Pachler's two requests that Zulfer enter an accrual in the internal books and records before the Board formally approved the bonus pool. The factual allegations in the Complaint here do not support a plausible inference that Zulfer had an objectively reasonable belief that Flanders and Pachler intended to deceive, manipulate or defraud Playboy's shareholders, for two main reasons.

First, as discussed above, Flanders, Pachler and Zulfer all were aware that numerous internal controls, including Board approvals, auditor review and Zulfer herself, stood between Pachler's accrual request and eventual issuance to shareholders of the Company's financial statements. As Zulfer acknowledges, Pachler actually followed proper internal control procedures by requesting that she make the accrual and not bypassing her by doing it himself. Thus, it is facially implausible to infer from her allegations that Flanders and Pachler knew or were deliberately reckless in not knowing that shareholders would be given false financial information and be misled by it. See Silicon Graphics, 183 F.3d at 976 (scienter includes "deliberate recklessness," which is defined as "an extreme departure from the standards of ordinary care, and which presents a danger of misleading [shareholders] that is either known to the defendant or is so obvious that the actor must have been aware of it") (emphasis added); see also In re Nat'l Golf Props. Sec. Litig., Case No. CV 02-1383-GHK(RZx), 2003 U.S. Dist. LEXIS 4321, at *25 (C.D. Cal. Mar. 18, 2003) ("To be liable [for securities fraud] a defendant must know or should know that his representations would be communicated to investors."). And, therefore, it is facially implausible to infer that Zulfer had an objectively reasonable belief that Flanders and Pachler could have had such a state of mind.

Second, the nature of the accounting issue itself undermines any inference that Zulfer could have had an objectively reasonable belief that Flanders and Pachler

intended to commit shareholder fraud. The accounting issue here is an "accrued expense":

> Expenses that are recorded before any bill has been received are called accrued expenses. Companies will record accrued expenses in order to make sure that their financial statements are accurate. Financial statements are prepared on the accrual basis, which means that cash does not have to change hands in order for something to be recorded.

Jeffrey R. Haber, Accounting Demystified 91 (2004). As Zulfer asserts in her opposition, the standard under GAAP governing expense accruals is set forth in Accounting Standards Codification ("ASC") 450-20-25-2. Under that ASC, an accrual for an expense is appropriate where "(1) the expense likely will be incurred and (2) the amount can be reasonably estimated." Opp. Mem. at 13 (emphasis added). GAAP does not require absolute certainty regarding the expense before making an accrual. As the language of ASC 450-20-25-2 makes clear, when making an accrual for an expense, management must exercise judgment about the likelihood the expense will be incurred and in estimating its amount.

The Supreme Court has long recognized that the provisions of GAAP "are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. . . . Rather, [they] tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management." Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 544 (1979). Thus, as the Ninth Circuit has observed, because accounting concepts are flexible, circumstances will give rise to fraud only where differences in calculations are the result of a falsehood, and "not merely the difference between two permissible judgments." In re GledFed, Inc. Sec. Litig., 42 F.3d 1541, 1549 (9th Cir. 1994) (en banc); accord DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002); In re Software Toolworks, Inc., 50 F.3d 615, 627 (9th Cir. 1994); see also Mathews v. Centex Telemanagement, Inc., Case No. C-92-1837-CAL, 1994 U.S. Dist. LEXIS 7895, at

*13-14 (N.D. Cal. June 8, 1994) ("This court need not reconcile those differences in opinion [as to accounting practices], because they are just that; that is, differences of opinion. They are not evidence of misstatements or material omissions.").

Day is illustrative. The employee in Day had numerous disagreements with management about an assortment of internal processes regarding, among other things, product returns and customer credits. He alleged that as a result of the processes he believed were defective, internal data were "manipulated" and "the information [the company] sends to Wall Street [wa]s inaccurate." 555 F.3d at 57. The Court rejected the employee's claim. As the Court explained, "[a] generalized allegation of inaccuracy in accounting is insufficient to establish a reasonable belief in a violation of GAAP, much less a reasonable belief in shareholder fraud." Id. (citing DSAM, 288 F.3d at 390 ("[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter" in a securities fraud action)). The Court in Day went on to note that "merely stating in conclusory fashion that a company's books are out of compliance with GAAP would not in itself demonstrate liability" for securities fraud. Id. (quoting In re Cabletron Sys., Inc., 311 F.3d 11, 34 (1st Cir. 2002)). "Claims that there has been accounting fraud thus require evidence beyond a belief in a mere accounting irregularity," the Day Court concluded, "and not even an accounting irregularity can be reasonably alleged here." Id. (emphasis added).

Zulfer's disagreement with Pachler's requests for an accrual reflects, at most, a simple difference of opinion about a reserve for a future expense. In Pachler's judgment, an accrual before Board approval of the bonus pool was an appropriately conservative approach to booking incentive compensation expense. In Zulfer's judgment, apparently, an accrual before Board approval of the bonus pool was too conservative an approach to booking incentive compensation expense. We say "apparently," because Zulfer does not allege that she reviewed the accounting

literature or did anything whatsoever validate her position on before rejecting Pachler's requests for an accrual.[3]

Zulfer fails to demonstrate that Pachler's judgment was outside a "range of 'reasonable' treatments" under the circumstances. Accordingly, under Ninth Circuit law, she fails to demonstrate that Pachler's requests for an accrual plausibly suggest fraud. As a result, Zulfer's allegations regarding Pachler's requests for an accrual before Board approval of the bonus pool, while arguably consistent with her theory of attenuated fraud, merely reflect the kind of "neutral territory" of allegations that the Courts in Twombly, Iqbal and Central Aluminum observed are insufficient to state a claim.

In her opposition memorandum, Zulfer refers to the language of ASC 450-20-25-2 and then asserts in conclusory fashion that booking an accrual before Board approval of the bonus pool violates that provision of GAAP. She offers no authority to support that assertion that Board approval of the bonus pool was required under GAAP before an accountant could properly determine, in the exercise of sound judgment, that the expense was "likely" and "reasonably estimable." She also offers no facts (or even reasoned arguments) "tending to exclude the possibility" Pachler's accounting judgment was not an accounting irregularity, but instead was within a range of alternative, reasonable accounting treatments under the circumstances.[4]

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[3] Even assuming that booking an accrual before Board approval of the bonus pool differed from past practice (see Opp. Mem. at 11), a change from past practice does not suggest that the new practice is wrong under GAAP — any more than it might suggest the opposite, i.e., that the new practice corrected a longstanding wrong practice under GAAP. This allegation, therefore, is neutral.

[4] As noted in our opening memorandum, Zulfer's unsubstantiated "suspicions" of Flanders' and Pachler's intentions and her allegations regarding unrelated prior "bad acts" fail to support a plausible inference of scienter. See Open. Mem. at 13-14. Zulfer appears to abandon these allegations in connection with her attempts to demonstrate scienter. See Opp. Mem. at 22. Zulfer does now argue (without citation to the Complaint) that Pachler's requests for the accrual somehow were "done to pressure the Board to approve bonuses that should not have been paid," because, she says, the entry of an accrual would make it "easier for [Flanders and Pachler] to lobby the Board to 'rubber-stamp' their approval."

Zulfer's scienter allegations thus fail under Twombly/Iqbal. Nor can she fix this deficiency; she is well aware that, in requesting the accrual, Pachler both (1) notified her that that Flanders was in communication with the Board regarding the bonuses and (2) explained that the bonuses could not be paid until Board approval.

3. Zulfer Fails to Plead an Objectively Reasonable Belief that Flanders and Pachler Were Engaged in a Violation of SEC Rules

Zulfer did not bother to identify in her Complaint which of the six categories of wrongdoing under SOX she was basing her claims. Perhaps recognizing that she cannot plead a claim under the sixth category (shareholder fraud), Zulfer turns to the fifth category, a violation of an SEC rule or regulation.[5] Specifically, she points to Section 13 of the Exchange Act and SEC Rule 13a-15 promulgated under Section 13 of the 1934 Act, 15 U.S.C. § 78m.[6]

The facts alleged in the Complaint, however, do not come close to pleading a violation of Rule 13a-15. That rule is limited to the description, purpose, maintenance and evaluation of systems of internal disclosure and financial controls. See 17 C.F.R. § 240.13a-15. Zulfer does not allege that Playboy failed to maintain or evaluate systems of internal disclosure and financial controls as described in Rule 13a-15. To the contrary, her allegation that Pachler twice requested that she book an

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Opp. Mem. at 15 n.6. If Zulfer really did hold this view, why didn't she do directly to any of her many contacts on the Board to warn them? Probably because it is speculative nonsense. After all, the Board went on to approve the bonuses even though the accrual was never made. Twombly/Iqbal require the Court to disregard this type of unsupported speculation in determining whether plaintiff's claim is plausible on its face.

[5] Zulfer's attempt to amend her complaint through her opposition brief is improper and should not be countenanced. See, e.g., Schneider v. California Dep't of Corrections, 151 F.3d 1194, 1197 n.1 (9th Cir. 1998).

[6] The fifth category of Section 1514A(a)(1) is limited to violations of "rules and regulations of the SEC." It does not include violations of statutory law, such as the 1934 Act itself. Accordingly, under the fifth category, Zulfer cannot rely upon alleged violations of Section 13(b) (such as Section 13(b)(5); see Opp. Mem. at 8)) that are not also violations of SEC rules and regulations. To the extent a handful of Zulfer's cases misread the plain language of Section 1514A(a)(1) to include violations of statutory law within the fifth category, the Court should disregard them as unpersuasive.

accrual is consistent with a system of internal controls. Zulfer seems to argue that Rule 13a-15 also addresses acts of purported circumvention of internal controls. See Opp. Mem. at 8. She is wrong. As the plain language of Rule 13a-15 makes clear, the rule does no such thing. In any event, Zulfer acknowledges that, far from circumventing Playboy's internal accounting controls, Pachler followed internal accounting controls by going through her to make the accrual and not bypassing her to make the accrual himself. Accordingly, even if Rule 13a-15 applied to alleged circumvention of internal controls, the allegations of the Complaint would not support such a claim.

Zulfer also argues that, in her view, Flanders and Pachler were not entitled to bonuses in light of the Company's 2010 financial performance. Opp. Mem. at 11. Zulfer later concedes that the decision on whether to grant bonuses rested solely with the Board. Id. at 14. If Zulfer's accounting judgment in refusing to book the accrual was clouded by her personal views (or resentment) toward her bosses' bonuses, it was Zulfer, not Pachler, who was disregarding proper internal controls and procedures by seeking to substitute her views over the judgment of the Board.

Zulfer does not cite SEC Rule 13b2-1 (regarding books and records) in her opposition, and the Court should not permit her to amend on the basis of this rule. Rule 13b2-1 makes it unlawful for any person to "falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the" 1934 Act. 17 C.F.R. § 240.13b2-1. Notably, Rule 13b2-1 does not, by its terms, declare unlawful attempted falsification of books and records. This is different from the mail fraud, wire fraud, bank fraud and securities fraud statutes, all of which include attempts to commit such frauds as violations themselves. See 18 U.S.C. § 1341, 1343, 1344, 1348. Here, as Zulfer admits, the accrual was never entered. Thus, no falsification could have occurred. At most, Zulfer alleges an attempted falsification. That is not a violation of Rule 13b-2.

Just one of Zulfer's cited cases, Mallory v. JP Morgan Chase & Co., 2009 WL 6470454 (U.S. Dep't of Labor ALJ Nov. 20, 2009), may have involved an attempt to commit a wrongful act that did not ultimately happen. There, the complainant suspected that a loan officer's submission of a draw request for approximately $17,000 in excess of the amount available on the loan was a potential violation of internal controls. Id. at *2. The complainant approved the draw request for less than the amount requested. Id. at *19. The ALJ's opinion denying summary judgment does not clarify whether the $17,000 was ultimately funded and the loan draw went through as requested, although there is a reference to "the loan officer's decision to submit the draw request himself," apparently bypassing the complainant. Regardless, Mallory is inapposite because the alleged wrongful acts at issue in that case were not violations of Rule 13b2-1, but rather mail fraud, wire fraud and bank fraud. As noted above, those statutes include "attempts" within their definitions. Rule 13b2-1 does not.[7]

Even if "attempted falsification" were within the scope of Rule 13b2-1, Zulfer's allegations still fall short. As discussed above, Ninth Circuit law is settled that a "difference between two permissible [accounting] judgments" is not a "falsehood." GlenFed, 42 F.3d at 1549; see also Mathews, 1994 U.S. Dist. LEXIS 7895, at *13-14 ("differences in opinion" as to accounting practices "are not evidence of misstatements"). In order for Zulfer to show that the requested accrual was a "falsehood," she must demonstrate through well-pled facts that Pachler's judgment that an accrual was appropriate under GAAP was outside a "range of 'reasonable' treatments." Thor Power, 439 U.S. at 544. For the reasons discussed above, Zulfer does not and cannot do so.

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[7] Administrative law judge decisions are not binding authority on a United States District Court. See Wiest v. Lynch, No. 10 Civ. 3288, 2011 WL 5572608, at *4 (E.D. Pa. Nov. 16, 2011) ("Controlling law means binding precedent—i.e., decisions of the United States Supreme Court or the Court of Appeals.").

In an effort to distract the Court from the deficiencies of her Complaint, Zulfer cites an assortment of cases and administrative decisions involving claims under the fifth category in Section 1514A(a)(1), most of which do not engage in any serious or careful analysis of the SOX categories at issue. See Opp. Mem. at 9-10. Only one of those cases, Morefield v. Exelon Services, Inc., 2004 WL 5030303 (U.S. Dep't of Labor ALJ Jan. 28, 2004), arguably involved matters of accounting judgment. In Morefield, the complainant raised concerns about alleged improper accounting treatment of vacant leases, improper balance sheet adjustments, manipulation of financial forecasts, manipulation of a budget and improper accounting treatment of liabilities. See id. at *1. The ALJ's opinion denying summary judgment does not go into any detail about these issues, so it is impossible to determine whether any of them actually involved, as here, a simple difference in accounting judgment. In any event, without any analysis of Supreme Court or other legal authority, the ALJ concluded summarily that the fifth and sixth categories under SOX "may provide ample latitude to include rules governing the application of accounting principles and the adequacy of internal accounting controls implemented by the publicly traded company in compliance with such rules and regulations." Id. at *6. This conclusion is contradicted by the more recent Circuit court authority in Day and Allen, which, as discussed above, require much more from a complainant to state a claim under SOX.

In the absence of specific factual allegations "tending to exclude the possibility" that Pachler's accounting judgment was within a range of alternative, reasonable accounting treatments, it is implausible to infer that Zulfer had a reasonable belief that Pachler's requests constituted an attempt to "falsify" Playboy's books and records in violation of Rule 13b2-1. Zulfer's Complaint is firmly within the "neutral territory" that the Courts in Twombly, Iqbal and Central Aluminum held are insufficient.

Finally, Zulfer argues that a showing of scienter is not required for her claim for violations of rules promulgated under Section 13 of the 1934 Act. Opp. Mem. at 19 (citing SEC v. McNulty, 137 F.3d 732, 740-41 (2d Cir. 1998); Mallory, 2009 WL 6470454, at *29). McNulty (on which Mallory relies) was not a SOX whistleblower case. It was a civil enforcement proceeding brought by the SEC. Mallory's (and thus Zulfer's) reliance on McNulty, therefore, was misplaced. In fact, the Fourth Circuit in Livingtson held squarely that any claim under the fifth category of SOX must, as with the other five categories, make a showing of fraud:

> We conclude that number (5) also refers to regulations prohibiting fraud. To conclude otherwise would absurdly allow a retaliation suit for an employee's complaints about administrative missteps or inadvertent omissions from filing statements. Moreover, the ambiguity is fully clarified by the context of the whistleblower provision in the Sarbanes-Oxley Act and by the legislative history that indicates that whistleblowing is protected by § 1514A when it relates to "fraud." See, e.g., S. Rep. No. 107-146, at 19 (2002) ("Although current law protects many government employees who act in the public interest by reporting wrongdoing, there is no similar protection for employees of publicly traded companies who blow the whistle on fraud and protect investors") (emphasis added); id. (noting that whistleblower provision protects employees who report conduct "which they reasonably believe to be fraudulent") (emphasis added).

520 F.3d at 352 n.1. "Fraud" under the securities laws connotes knowing or intentional misconduct — i.e., scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1975). For the reasons set forth in Section II.B.2, supra, Zulfer's claim based upon the fifth category of SOX fails to show "more than a sheer possibility" that Flanders and Pachler acted with scienter. Zulfer's fifth category SOX claim must be dismissed.

C. Zulfer Fails to State a Claim for Violation of Labor Code Section 1102.5

In the opening memorandum, Playboy demonstrated that Zulfer's second cause of action under Section 1102.5 of the California Labor Code should be dismissed. See Open. Mem. at 15. As explained, to state a claim under Section 1102.5(c), the employee must have refused to engage in an act he or she reasonably believed would violate a state or federal statute, rule or regulation; and to state a claim under Section 1102.5(b), the employee must have made a report "to a government or law enforcement agency." Id. (citing Cal. Labor Code § 1102.5(b)). Zulfer fails to allege facts sufficient to show that she refused to participate in an act that would have resulted in a violation SOX (or any other state or federal statute, rule or regulation), and fails to allege that she reported her concerns to a qualifying governmental or law enforcement agency.

Zulfer effectively concedes that to state a claim under Section 1102.5(c) her SOX claim must survive dismissal. See Opp. Mem. at 23. With respect to the statutory requirement that she have made a report to a government or law enforcement agency, Zulfer argues that the Court should ignore the plain language of the statute and expand Section 1102.5(b) to cover her alleged internal report to the Company's General Counsel. As Zulfer acknowledges, however, her only authority for this argument (Gardenhire v. Housing Authority, 85 Cal. App. 4th 236 (2000), and Colores v. Board of Trustees, 105 Cal. App. 4th 1293 (2003)) involved employers that were themselves government agencies. Zulfer nevertheless argues that Playboy should be treated as a government agency because the Company has "its own reporting obligations to the government." Opp. Mem. at 23-24.

Under Zulfer's novel and unprecedented view of Section 1102.5(b), the statute would cover virtually every internal employee complaint, as most, if not all, employers have some reporting obligations to the government, such as reporting income to the Internal Revenue Service and the State Franchise Tax Board, maintaining state licensure, complying with insurance, health and requirements, just

to name a few. The Court should decline Zulfer's invitation to rewrite Section 1102.5(b) to expand its scope so dramatically.

D. Zulfer Offers No Basis for Denying Playboy's Motion to Strike

1. Allegations Pertaining to the SOX Claim Must be Stricken From Zulfer's Wrongful Termination Cause of Action

In the event the Court dismisses Zulfer's SOX claim, Zulfer will be unable to allege a wrongful termination cause of action based upon alleged "suspicious" accounting practices. Accordingly, allegations relating to her SOX claim must be stricken from her separate wrongful termination cause of action. See Open. Mem. at 16-17. Zulfer offers nothing of substance in opposition to Playboy's motion to strike, and not one of the cases she cites stands for the proposition that she claims. Rather, Zulfer offers incomplete and distorted quotes and case citations in attempt to mislead the Court. For example, Zulfer argues that Collier v Superior Court, 228 Cal. App. 3d 1117 (2003), held that an internal report involving a criminal act affects the public at large per se. Opp. Mem. at 24. That is not accurate. In Collier, the employee's report concerned a billing scheme that overcharged the employer's customers. Collier, 228 Cal. App. 3d at 1122-23. The court held that a wrongful termination claim only lies where the employee's report affects the interests beyond those of the employer. See id. (plaintiff's report was sufficient to support a wrongful termination claim because it "served not only the interests of his employer, but also . . . the interests of innocent persons who stood to suffer specific harm from the suspected illegal conduct"). Thus, contrary to Zulfer's assertion, Collier in no way supports the notion that an internal complaint, even one that concerns criminal activity, can support a wrongful termination claim, unless it implicates the public at large. Here, of course, the challenged accounting issue was purely internal and never came close to affecting the Company's shareholders or the public at large. See Section II.B.1, supra.

Zulfer's discussions of Franklin v. Monadnock Co., 151 Cal. App. 4th 252 (2007); Haney v. Aramark Uniform Services, Inc., 121 Cal. App. 4th 623 (2004); and Sullivan v. Delta Airlines, Inc., 58 Cal. App. 4th 938 (1997), are similarly misleading. Not one of these cases stands for the proposition that an internal report not tied to a benefit that inures to the public can form the basis of a wrongful termination claim. Accordingly, absent pleading a viable SOX claim, Zulfer's allegations regarding her alleged internal report is an internal matter that has no tie to a public policy, and as such must be stricken.

2. Zulfer's Irrelevant Allegations Against Scott Flanders Must Be Stricken

Playboy properly moves this Court for an order striking allegations in the Complaint about Flanders that have absolutely no bearing on any alleged suspect accounting practices or shareholder fraud, and are an obvious abuse of the litigation privilege. See Open. Mem. at 17-18. Tellingly, Zulfer's tepid response to Playboy's motion to strike these impertinent and irrelevant allegations is buried in footnote 14 of her opposition. See Opp. Mem. at 25 n.14. Zulfer asserts in a conclusory fashion that her awareness of alleged "improper" conduct by Flanders is relevant to her "suspicions" about Flanders' motives, and to the objective and subjective prongs of the reasonably belief element of her SOX claim. Id. Nonsense. Zulfer never bothers to explain the connection between the disputed allegations and her SOX claim, nor does she offer a shred of authority for the proposition that the allegations made against Flanders have bearing on the elements of any of her claims. Id. Accordingly, Zulfer's allegations regarding Flanders are immaterial, impertinent and scandalous and must be stricken.

E. Zulfer Should Be Denied Leave to Amend Because She Cannot Cure the Defects in the Complaint

Based upon the admissions in the Complaint and the undisputed timeline of Playboy's financial disclosures of which this Court can take judicial notice, Zulfer

cannot in good faith allege that she had an objective, reasonable belief that her complaint approximated the elements of a shareholder fraud claim or violation of SEC rules, nor can she plead a claim under Section 1102.5 or wrongful termination (as based on the alleged SOX violation). Accordingly, dismissal of the first and second causes of action should be with prejudice.

In her opposition, Zulfer makes no proffer whatsoever of additional specific facts she would allege in any amended complaint that might save her SOX claim from dismissal. See Opp. Mem. at 22-23. The Court has no basis, therefore, on which to conclude that amendment would serve any purpose. Furthermore, Zulfer does not request leave to amend with respect to her second cause of action under Labor Code § 1102.5, tacitly admitting that she has nothing to add toward that claim.

III. CONCLUSION

For the foregoing reasons, and for the reasons set forth in its opening memorandum, Playboy respectfully requests that this Court (a) dismiss Zulfer's first and second causes of action, with prejudice, (b) strike portions of the fourth cause of action for wrongful termination and (c) strike from the Complaint those allegations that Playboy has identified as immaterial, impertinent and scandalous.

Dated: Januarv 28. 2013 SHEPPARD. MULLIN. RICHTER & HAMPTON LLP

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